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IN THE

Supreme Court of the United States

October Term, 1958.

No. 218.

EMORY W. PARSONS, ERMA M. PARSONS, et al.,
Petitioners,

v.

FRANCIS R. SMITH, Former Collector of Internal Revenue for the First District of Pennsylvania,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

Reply Brief for the Petitioners.

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ARGUMENT.

In arguing that Parsons had no economic interest, Respondent and Paragon Jewel Coal Company ("Paragon"), as amicus curiae, have raised certain points which warrant a brief response.

The crucial fact which Respondent has ignored is that Parsons is a coal operator in the business of mining coal. In previous cases involving the existence of an economic interest, the issue before this Court has invariably involved one who did not actually participate in mining, but in some fashion received income dependent upon the success of a mining operation performed by another. This circumstance has led to the consideration whether there is, as Respondent describes it (Br. 35), "a substantial nexus" between that person and the mineral in place. Here, however, it is the miners themselves who seek the depletion. It is difficult to conceive of a person having a closer connection to, and interest in, the mineral than the one who has the right to mine it and convert it to cash.

A. The Fact That the Parsons' Contract Was Terminable Is Irrelevant.

1. Respondent concedes that a stripper's contract right to extract coal may constitute an economic interest in the coal, even though his contract is terminable.[1] He argues, however (Br. 32), that if the contract is terminable, it constitutes an economic interest only if the stripper has the right to remove a "substantial and significant" portion of the deposit. This argument proceeds from a fundamental misconception of the depletion allowance.

Contrary to Respondent's belief (Br. 22-23), we do not dispute the fact that the purpose of the depletion deduction is analogous to depreciation. Both are intended to

1. Since he nowhere expressly relies upon the fact that Parsons was paid a stated price per ton, Respondent apparently concedes it to be irrelevant.

recompense taxpayers as their assets are worn out or used up. However, the Respondent misses the significant difference between the two deductions: the manner in which this basic purpose is achieved.

Originally depreciation and depletion were exactly the same. In both the basis to be depreciated or depleted was the cost paid by the taxpayer. In 1918, however, the depletion statute was amended to provide that taxpayers could use as their basis the value of the mineral deposit.[2] Under this "discovery value" depletion the taxpayers' deductions related to what they acquired, and not (as in the case of depreciation) what they had paid. This permitted them to recover through depletion deductions far more than their cost. As this Court said in *Palmer v. Bender*, 287 U. S. 551,558 (1933):[3]

> "The statute makes effective the legislative policy, favoring the discoverer of oil, by valuing his capital investment for purposes of depletion at the date of the discovery rather than at its original cost."

To remove the difficulty of valuing hidden deposits, Congress enacted[4] percentage depletion as an administra-

2. Revenue Act of 1918, §§ 214(a)(10), 234(a)(9), 40 Stat. 1067-8, 1078-9.

3. The Committee reports cited in Petitioners' principal brief state that the intent of Congress in enacting discovery value depletion was "to stimulate prospecting and exploration," S. Rep. No. 617, 65th Cong., 3d Sess. 6; "to encourage the wildcatter or pioneer", H. R. Rep. No. 1, 69th Cong., 1st Sess. 6; and "to stimulate prospecting for new deposits of mineral and oil," S. Rep. No. 27, 69th Cong., 1st Sess. 3. Accordingly, Congress gave mineral producers a larger basis than other taxpayers upon which to compute deductions for exhaustion. We do not contend that this fact alone establishes taxpayers' right to depletion. We do urge, however, that in determining the existence of such right, it is significant that Parsons, being the miner who bore the risk of discovery, is within the class which Congress intended to benefit.

4. Revenue Act of 1926, § 204(c)(2), 44 Stat. 16 (oil and gas); Revenue Act of 1932, § 114(b), 47 Stat. 202-3 (coal).

tive substitute for discovery depletion. Under percentage depletion it is unnecessary to determine the value of the mineral interest acquired. The deductions continue as long as the taxpayer derives gross income from the property, irrespective of its value.

Thus a taxpayer may have a capital investment in the mineral which will support depletion even though he has paid nothing for it. In addition, whether the interest is "substantial and significant" is irrelevant. The comparative value of the interest relates only to its size and not to the creation of it in the first instance.

Respondent does not say what is a "substantial and significant" portion of the coal. By whatever standards the determination is to be made, the rule can lead only to hopeless confusion unless arbitrary determinations are to be sanctioned. Respondent ignores the inherent difficulty in determining a stripper's rights in relation to a hidden coal deposit, the extent of which is unknown. Indeed, Respondent's test harks back to the days of discovery value depletion and revives the type of administrative burden which Congress sought to remove by the enactment of percentage depletion.

2. Respondent seeks to distinguish the *Southwest* case on the issue of terminability by saying that in that case termination would have brought an end to production, whereas here production might be continued by another operator (Br. 35). In fact, Southwest had the right to modify as well as terminate its state lease without liability to the upland owners and, upon a change in the California law, could have terminated the agreement with the upland owners and continued to produce oil. The upland owners had no assurance that they would receive net profits as long as oil was produced. Contrary to Respondent's assertion, the termination of the agreements with the upland owners would not necessarily stop production. Hence the distinction which he seeks to make fails. In any event, as this

Court said in *Southwest*, the possibility of termination never occurred. 350 U. S. at 316.

B. Parsons Acquired an Economic Interest, Not an Economic Advantage.

1. Respondent relies heavily (Br. 27-30) upon two decisions of this Court holding that the taxpayers there involved had no economic interest in the mineral, but had only an "economic advantage". *Helvering v. Bankline Oil Co.*, 303 U. S. 362 (1938); *Helvering v. O'Donnell*, 303 U. S. 370 (1938). These cases are two examples of those involving taxpayers who were not actual producers of the mineral. In the *Southwest* case the Court indicated the basis for decision of such cases: taxpayers who are not actual producers have an economic interest only if they contribute something essential to production, either in the form of the land under which the mineral lies, or, as in the *Southwest* case, an asset without which the mineral cannot be mined. The taxpayers in *Bankline* and *O'Donnell* did neither. In short, they had nothing whatever to do with production, and in the words of the statute as applied to coal, they received no "gross income from mining". Accordingly, they acquired merely an economic advantage from a third party's mining operation. In the present case, of course, there is no need for such inquiry; the taxpayers are in fact the miners.

2. Despite the fact that it is the miners themselves who are here involved, Respondent nevertheless argues (Br. 30) that the taxpayers contributed nothing essential to production because the owners might have contracted with different operators. But any lessor of coal or oil lands may choose any person as lessee. Indeed, in the *Southwest* case itself it appears that although the upland owners were essential to production as a class, no one of them was essential individually. The oil operator could have chosen equally among six upland owners, but used the land of only three.

The only question is whether what was in fact contributed was essential to the mining. It is obvious that the contribution of the miner himself is essential. His rights cannot depend upon whether some other operator might have mined the coal.

C. Respondent's Alternative Argument Constitutes a Repudiation of the Announced Position of the Treasury Department, as Well as His Own Prior Position.

Respondent argues alternatively (Br. 37) that even if its contract were not terminable, Parsons nevertheless made no "capital contribution which would constitute . . . an investment" in the mineral in place.[5] The thrust of this argument would reach all strippers.

Parsons and Huss are not unique. Their equipment is the same kind as that committed by the operators in every other stripping case presented to the courts. In net effect, Respondent argues that no stripping contractor is entitled to depletion.

This position is not only contrary to the Treasury Department's published ruling in GCM 26290,[6] but is likewise

5. Similarly, Paragon contends that the taxpayers cannot have an economic interest in the property because their interest was not acquired by capital investment. Although Paragon uses the words "capital investment" over three score times in its brief, it never defines them. In such circumstance, it is fair to inquire what "capital investment" Paragon has in its coal arrangement. Paragon is a lessee of coal lands, and its lease requires it to pay taxes and royalties. It also incurs expenses in building roads, tipples and otherwise preparing the property for drift mining. The royalties and taxes paid by Paragon are, of course, deductible for tax purposes, and its other expenditures in respect of the property are either subject to depreciation or directly deductible as expenses. Paragon asserts that expenses of this type are not sufficient to support the taxpayers' capital investment. By its own admission Paragon has nothing more or different invested in its lease than the taxpayers in their stripping contracts. If the taxpayers have no capital investment, neither does Paragon.

6. 1950-1 Cum. Bull. 42.

contrary to Respondent's position in every case in which he supported the right of the coal stripper to depletion. *E.g., Commissioner v. Mammoth Coal Co.*, 229 F. 2d 535 (3d Cir. 1955), *cert. denied*, 352 U. S. 824 (1956); *Commissioner v. Gregory Run Coal Co.*, 212 F. 2d 52 (4th Cir. 1954), *cert. denied*, 348 U. S. 828 (1954). It conflicts also with every decided coal stripper case, all of which have assumed that strippers can have an economic interest.[7]

D. Section 631(c) of the Internal Revenue Code of 1954, First Enacted in 1951, Clearly Has No Relevance to the Present Issue.

Proceeding on the erroneous premise that "petitioners' case must stand or fall" on the provision of the statute requiring equitable apportionment of the depletion deduction between lessor and lessee, Paragon asserts (Br. 47) that legislation first enacted in 1951, and now appearing as Section 631(c) of the Internal Revenue Code of 1954, constitutes an "additional reason" why the taxpayers are not entitled to depletion.

We agree that no party—government, coal company or strip miner—and no court has ever made this point. We think the reason is plain: the legislation in fact has no relevance to these cases. Even though Respondent makes no reference to the point in his brief, we believe that some brief comment is appropriate.

1. Parsons' right to depletion does not depend upon the existence of the equitable apportionment provision in the statute dealing with lessors and lessees. The depletion allowance must be apportioned among all parties having an economic interest in the property. *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312 (1934). As this Court said in *Palmer v. Bender*, *supra* at page 557, the lessor-lessee apportionment provision of the statute "presupposes that the deductions may be allowed in other cases."

7. The same, of course, is true of Paragon's position.

2. The legislation to which Paragon refers simply provides that the disposition of coal with a retained economic interest by an owner who is not engaged in mining shall be treated as if it were a sale, even though it would not qualify as a sale under general principles. Gains are treated as capital gains, and losses are fully deductible. Since the transaction is treated as if it were a sale, percentage depletion would not be allowed to the seller whether or not the statute said so.

The tax treatment accorded a passive owner of coal who is not engaged in mining obviously can have no bearing on the tax treatment of one engaged in mining, whether as lessee or otherwise, particularly where by its very terms the statute is expressly inapplicable to persons so engaged. Although Paragon characterizes the lessee's depletion as "indivisible" (Br. 50), it recognizes that a lessee today receives precisely the same amount of depletion he received prior to the enactment of this statute. In short, the statute has no effect on the depletion of a lessee or anyone else except the passive owner not engaged in mining.

3. Paragon points to the difference between the definition of an owner in subsection 631(b) of the Internal Revenue Code of 1954, dealing with timber, and subsection 631(c), dealing with coal. It asserts that the difference demonstrates that Congress did not intend "to allow any percentage depletion to the taxpayer who simply has a contract to mine coal" (Br. 51). This difference demonstrates no such intent. On the contrary, it is necessary because of a basic difference in the two subsections which Paragon apparently overlooks. The coal subsection applies only to owners who are not engaged in mining. The timber subsection is not so limited. One deriving income from a contract to mine coal is not covered by the statute. He is engaged in mining. Manifestly, he could not be included in the definition of an owner to be covered by the statute. To do so would be self-negating on its face.

4. Paragon concedes (Br. 54) that the Committee reports dealing with the 1951 amendments do not discuss the right of a strip miner to depletion. Since the legislation has nothing to do with the question, any discussion of it would be clearly irrelevant. However, Paragon says that the "reports could not possibly have mentioned the problem considered in the present case, for the reason that it had not then arisen." This ignores GCM 26290, which was issued in March, 1950 for the precise purpose of setting out the Treasury Department's position on the coal stripping depletion problem. Clearly, when the 1951 legislation was considered, the strip miner's problem was there for all to see.

5. Finally, whatever inference Paragon seeks to draw from its assertion (Br. 52) that the words "economic interest" first appeared in the statute in 1951 must fail. The words "economic interest" first appeared in the law in the Revenue Act of 1943.[8] All that was done in the Revenue Act of 1951 was to add rules respecting the tax treatment of a disposition of coal by a non-miner to an existing section of the law originating in 1943 which contained the words "economic interest."

CONCLUSION.

The decision of the Court of Appeals should be reversed.

Respectfully submitted,

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8. Revenue Act of 1943, § 117(k)(2), 58 Stat. 47.